Investment Canada Act aims to protect national security: How to enhance foreign M&A success

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Overview

In April 2020, the federal government announced it would be using the *Investment Canada Act* (ICA) to "subject certain foreign investments into Canada to enhanced scrutiny and over the last two years, it has been true to its word. For the only year during that time for which data is available (from April 1, 2020 to March 31, 2021), the government sent 23 notices of potential national security reviews (NSRs)—almost as many as the four previous years combined. Throughout 2022, Canada has implemented policy changes targeting sensitive sector investments—particularly by foreign state-owned or influenced investors (SOEs)—and introduced legislative changes[1] that will further tighten scrutiny on foreign investment in sensitive sectors and by SOEs in 2023.[2]

Key takeaways

- Mergers and acquisitions are now much more likely to be blocked by the Canadian government if they seem to impinge on Canada's "national integrity" and may be blocked simply because of the potential buyer's country of origin.
- Proposed changes to the ICA will identify certain sectors in which foreign investments of any value into Canada will need to be notified in advance, and such investments will likely be subject to a waiting period. The government would also be allowed to unilaterally impose conditions on a transaction while a national security review is underway.
- Although foreign investment into Canada may be more challenging, steps will remain that investors, and Canadian targets, can take to minimize deal risk and streamline the process.

While Canada, like many other countries, has had a form of investment screening for many years, the parameters for blocking a foreign investment were somewhat different. Prior to 2020, NSRs were largely reserved for significant investments by state-owned or state-influenced investors into industries considered critical to Canada's safety or infrastructure.

Now, that has all changed. While the national security tests remain the same, the interpretation of what falls into the category of "national security" is more expansive, and it is now significantly more common for mergers and acquisitions (M&A) to be blocked if they seem to impinge on our "national integrity." For instance, in the past, the government blocked deals only under extreme circumstances—such as when several resource deals would have allowed China to gain an inordinately high ownership stake in Canada's natural resource sector—today, a deal may be blocked simply because of the potential buyer's country of origin. In fact, Ottawa has made clear that transactions involving investments from SOEs in critical minerals will only be approved on an "exceptional basis" – and this scrutiny applies to minority, non-controlling investments, and/or where the critical mineral assets are not even located in Canada. The federal government has put this policy into action already, ordering the divestiture of interests held by Chinese stakeholders in Canadian companies and assets.[3] While the stated objective is to protect Canada's interests, it cannot be left pushed aside that the clear target of this legislation is Chinese (or other states that may not be aligned with Canada's values) investment, direct and indirect, in critical minerals that are important for Canada and its allies' growth, prosperity and security. Ottawa's reach will extend more broadly than critical minerals, but will also likely target big data, artificial intelligence, significant intellectual property and other strategic industries.

The reasoning behind this shift can be tied back to rising geopolitical volatility. Indeed, the Minister of Innovation, Science, and Industry (Minister) cited this exact reason while proposing new changes to the *Investment Canada Act*. Over the last five years, potential threats to Canada have evolved. Our relationship to China has become more strained and there is a sense that China is advancing non-commercial agendas through investment. As a result, the government has started to pay closer attention to the potential underlying intention of individual deals, and explore whether they expose us to new risks, such as cybersecurity threats[4].

The war in Ukraine has also underscored the difference between "friendly" and "unfriendly" jurisdictions, and exacerbated the risks associated with doing business with the latter. Earlier this year, the Investment Review Division of Innovation, Science and Economic Development Canada released a policy statement indicating that investment with ties to Russian entities and/or investors would face enhanced scrutiny.[5]

These trends and the unpredictability of government deal blockages have made life increasingly difficult for organizations, investment bankers and government contractors trying to navigate the foreign M&A investment space. Here, we will explore some of the challenges that have arisen in this new environment, forthcoming changes to the *Investment Canada Act* and how stakeholders can proactively respond to them.

A broader scope

In Canada and many other jurisdictions, national security review processes are largely shrouded in secrecy, with very little transparency into what types of deals can withstand government scrutiny. For instance, in the current environment, when governments evaluate a deal, they may consider the country in which a potential counterparty is located and whether it is considered an "unfriendly" jurisdiction. They may also consider whether the actions of a certain jurisdiction are aligned with Canadian ethical standards. At the same time, they may evaluate an investor's country of origin, the nature of the

deal and even the nature of the customers the deal will be serving, if those customers could somehow be perceived to endanger national security.

To complicate matters, assessing for national security under the now expansive approach to its scope is not straightforward. Due to political hyperactivity, regulators are not always clear where a company may stand. While they may have offices in Russia, for example, they might not be involved with malicious actors—but this can be hard to determine. Given these factors, and others, investors, company management teams and boards are finding it difficult to properly assess the risks of a deal and are subsequently being subjected to government rejections with little, if any, explanation.

Changes to the ICA

The proposed amendments to the ICA (and going forward, national security reviews) are aligned with the Canadian government's foreign policy and economic priorities. The key feature is that foreign investments in sensitive sectors (which have not yet been identified) will now need to be notified in advance of implementation under the national security rules, giving the Minister the opportunity to assess whether an NSR will be required.

Recent government actions and statements provide a good indicator of the sectors likely to be impacted. As discussed above, the government has already announced that it will significantly increase scrutiny of investments into the Canadian critical minerals (*i.e.*, lithium, graphite, nickel, cobalt, among others) sector by SOE investors. Therefore, it is nearly certain that these sectors will be included. Other statements and publicly revealed NSRs have identified critical infrastructure, sensitive personal information or data, artificial intelligence and the transfer of significant intellectual property as other areas of interest that will likely be included.

Additionally, with these changes, if an NSR is initiated, the Minister will be able to unilaterally impose conditions on a transaction while the NSR is underway if he, in consultation with the Minister of Public Safety, determine that they are necessary to prevent injury to national security that could take place during the review. This power applies to all NSRs, not just those in the sensitive sectors. There is no limit to the conditions that can be imposed under this new power, but they may include obtaining approvals for proposed business locations, creating approved corporate security protocols to safeguard information and access—such as details on cybersecurity, visitor logs, etc.—or granting access to facilities for compliance inspections.

Finally, these changes bring increased timing risk to covered investments. Currently, the minimum waiting period is 45 days however, if a national security review is ordered, the timing can be up to200 days, or in some cases more. It is unclear whether this 45-day period will be applied to investments subject to the new filing requirement. If it is, this will effectively impose a 45-day waiting period on all such investments. The changes will also make it easier for the Minister to extend certain timeframes on his own initiative.

A new approach

Fortunately, while the path to foreign M&A approvals is not as clear-cut as it once was, there are still best practices you can adapt to mitigate the risk of rejection.

- **Add a new layer to the deal assessment process.** Ultimately, when regulators conduct national security assessments related to cross-border deals. Recognizing this, investment banks and government contractors should assess whether a deal is likely to go through by looking at things like the nature of a counterparty. To increase the odds, some organizations are focusing on counterparties based in jurisdictions—such as the United States, United Kingdom, Europe, Japan, South Korea, Singapore and Australia—over those that are considered unfriendly. Given the recent pronouncement by the federal government in respect of transactions involving critical minerals, great consideration must be given to whether the circumstances are such that "exceptional basis" upon which an SOE investment in that sector will be permitted are present.
- **Conduct a 360-degree review early.** Given the opaqueness of the NSR process, it can be all too easy for boards and senior management to overlook NSR deal risks in their preliminary assessments. To identify as many deal risks as possible, including NSR, it can be helpful to conduct a 360-degree review early on—and invite advisors with experience in navigating the NSR process to take part. These professionals will be able to help you analyze whether a proposed investment would trigger national security concerns.
- **Consider where money is coming from.** In a similar vein to the 360-degree review, it is important for businesses to thoroughly examine where their investors' funds are coming from. Many sophisticated investors—such as major pension funds or sovereign wealth funds—have playbooks for dealing with this issue. To streamline the process, though, they may want to update it to reflect current Canadian realities and perhaps start the process earlier than they did in the past.
- **Balance financial and non-financial elements.** With a robust process at the outset, it is easier to identify investment opportunities likely to pass government scrutiny and to assess the desirability of a deal more intelligently on this basis. Often this means that the highest offer may not be the best option. In most cases, companies must weigh the financial side of the deal against the likelihood of its closing.

Bolster your chances of approval

Executing a transaction with certain foreign counterparties in today's politically volatile global environment can be challenging but is rarely impossible. By adapting your due diligence approach and adding additional safety measures to the process, it is possible to successfully and efficiently execute and close cross-border deals.

[1] Bill C-34, *An Act to amend the Investment Canada Act*, 1st Sess, 44th Parl, 2022, available online. For more information, please see our backgrounder entitled Canada unveils significant changes to the *Investment Canada Act*, available online.

[2] Innovation, Science and Economic Development Canada, "Annual report 2021-2022" (available online), February 2, 2022.

[3] Innovation, Science and Economic Development Canada, "Government of Canada orders the divestiture of investments by foreign companies in Canadian critical minerals companies" (available online), November 2, 2022.

[4] The *Guidelines on the National Security Review of Investments* emphasize that investments enabling access to sensitive personal data (*i.e.*, biometric or financial data) may be assessed for potential exploitation.

[5] Innovation, Science and Economic Development Canada, “Policy Statement on Foreign Investment Review and the Ukraine Crisis” (available online), March 8, 2022.

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